

APPENDIX A

THE ECONOMICS RESOURCE GROUP, INC.

The Economics Resource Group, Inc.
One Vinton Place
Cambridge, Massachusetts 02132-1946
(617) 491-4500 FAX (617) 491-3524

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January 5, 1998

RUELL... R. WONG

Robert F. Ochs, Esq.
Legal Department
Conoco, Inc.
P.O. Box 4783
Houston, Texas 77210-4783

Dear Mr. Ochs:

You have asked me to review Conoco's "bid-out" program by which certain of Conoco's interests in domestic crude oil production are put up for sale through a public bidding program. In particular, you have asked me to evaluate whether and to what extent the bid-out program can be relied upon to yield accurate measures of the market value of the oil at the lease. I have discussed the design and implementation of the program with Conoco personnel. I have also learned about the operation and outcomes of the program during its first few months of activities.

Conoco's bid out program is one by which Conoco solicits bids from unrelated parties to purchase some or all of its crude oil production in various producing regions. For each producing area that participates in the program, Conoco offers ten percent of Conoco's production volume for sale. For many areas, bidders, at their option, may bid for any amount between ten percent and all of Conoco's crude oil production. Any sale that occurs under the program is an outright cash sale under standard terms and conditions. The term of the sale is for six months; the bid price is established as a premium or deduction from a relevant posting, generally Koch's. Bids are solicited from numerous (over 20) bidders. Conoco reserves the right to reject all bids; otherwise it sells the oil at the highest qualified bid price.

Basic economic reasoning leads to the conclusion that the best indication of fair market value is outright cash transactions between reasonably informed, unrelated parties with adverse interests in the transaction. Based on my understanding of the design and operation of

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Conoco's bid-out program, the bid prices revealed will generate a reliable measure of the fair market value of Conoco's crude at the lease or in the field.

The design and implementation of the bid-out program clearly meets the economic criteria for achieving fair market value.

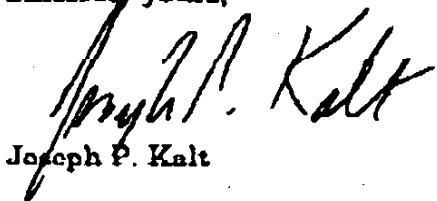
- Conoco provides appropriate information to all interested, qualified bidders and has itself solicited bids from potentially interested bidders. Where Conoco has applied its program, there appears to be an active and competitive market for crude at the lease or in the field as demonstrated by the number of potential and actual bidders. This is consistent with the overall structure of the domestic crude market in which there is active competition to purchase crude in the field. No particular number of actual bids, however, is required for the program to provide a reliable measure of market value. It is only required that the bidding process give effect to the forces of supply and demand that jointly determine fair market value. Based on my understanding, the Conoco program clearly meets this standard.
- Offering for bid ten percent of Conoco's volume in any given producing area is, in general, more than adequate for market forces to reveal fair market value of the crude. There is no need for the percentage to bear any relation to Conoco's royalty or working interest obligations in the area. The design of the program provides the opportunity for market forces, as expressed in arm's length bids, to operate.
- Conoco's right to refuse to sell some or all of the crude and instead exercise the implicit option economically to purchase the crude for itself does not invalidate the high bid price as a measure of fair market value. As long as there is a reasonable expectation on the part of bidders that some amount of crude will be sold in a significant portion of the bids, bidders will have the incentive to analyze the offer and prepare bids consistent with their objectives and their understanding of market conditions.
- The terms of the bid -- the standard terms and conditions, the six month term and pricing basis as a premium or deduction off of the relevant Koch or other postings -- are consistent with marketing practices in the industry. Consistent with the use of good marketing practices intended to enhance the market value of the crude, rather than marketing 10% of all crude that must be trucked from the lease on a well-by-well basis, Conoco selects some representative wells in an area and offers all of the production from those wells for bid. This method used by Conoco will tend to reduce transaction costs to bidders

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and result in higher bid prices. To the extent the wells are representative of production in the area, prices under the program will represent fair market value for the crude in the area.

If you have any additional questions or request additional information, please give me a call.

Sincerely yours,


Joseph P. Kalt

VALUATION PROBLEM POINTS UNDER MMS 2ND FURTHER SUPPLEMENTARY PROPOSED OIL VALUATION RULE

MMS 2ND FURTHER SUPPLEMENTARY PROPOSED RULE DATED 7/16/98		DESCRIPTION OF PROBLEMS
SECTION		
1.	206.100	<p>Affiliate means a person who controls, is controlled by, or is under common control with another person.</p> <p>(c) For this subpart, based on ownership of an entity's voting securities, interest in a partnership or joint venture, or other forms of ownership:</p> <ul style="list-style-type: none"> (i) Ownership greater than 50 percent constitutes control; (ii) Ownership of 10 through 50 percent creates a presumption of control; and (iii) Ownership less than 10 percent creates a presumption of non control that MMS may rebut if it demonstrates actual or legal control, including but not limited to interlocking directorates. <p>(2) MMS may require the lessee to certify the percentage of ownership. Aside from the percentage ownership/criteria relatives, either by blood or marriage, are affiliates</p>
2.	206.101	<p>Area means a geographic region at least as large as the limits of an oil field, in which has similar quality, economic, and legal characteristics.</p>
3.	206.101	<p><i>Arm's length contract</i> means a contract or agreement between independent persons who are not affiliates and who have opposing economic interests regarding that contract. To be considered arm's length for any production month, a contract must satisfy this definition for that month, as well as when the contract was executed.</p>
4.	206.101	<p>"Exchange" is defined in terms of physical delivery only. It should also be defined in terms of "transfer of title," and should not be defined as to exclude it</p>

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	<p>Exchange agreements may or may not specify prices for the oil involved. They frequently specify dollar amounts reflecting location, quality, or other differentials.</p> <p>Exchange agreements include buy/sell agreements, which specify prices to be paid at each exchange point and may appear to be two separate sales within the same agreement.</p>	<p>from the commercial understanding and the LCC definition of a "sale of goods," particularly where there is additional consideration under the agreement.</p>
5.	<p>Field means a geographic region situated over one or more subsurface oil and gas reservoirs and encompassing at least the outermost boundaries of all oil and gas accumulations known within those reservoirs, vertically projected to the land surface.</p> <p>State oil and gas regulatory agencies usually name onshore fields and designate their official boundaries. MMS names and designates boundaries of OCS fields.</p>	<p>Definition of field, like the definition of "area" also affects comparability issues, and like "area," the definition of field leaves much to the MMS discretion on an individual case basis.</p>
6.	<p>Gathering means the movement of lease production to a central accumulation or treatment point on the lease, unit or communized area, or to a central accumulation or treatment point off the lease, unit, or communized area that BLM or MMS approves for onshore and offshore leases, respectively.</p>	<p>MMS' definition of "gathering" under both the current regulations and proposed rules includes movement to a "central accumulation or treatment point off the lease." Because of the evolution of new market centers and hubs on gathering and transmission facilities, this definition should clarify that gathering is the movement to the "initial central accumulation point" both on and "adjacent to the lease." Reference to "off the lease" should be revised to "adjacent to the lease."</p>
7.	<p>Gross proceeds means the total monies and other consideration accruing for the disposition of oil produced. Gross proceeds include, but are not limited to, the following examples:</p> <ul style="list-style-type: none"> (1) Payments for services such as dehydration, marketing, measurement, or gathering which the lessee must perform at no cost to the Federal Government; (2) The value of services, such as salt water disposal, that the producer normally performs but that the buyer performs on the producer's behalf; (3) Reimbursements for harboring or terminaling fees; (4) Tax reimbursements, even though the Federal royalty interest may be exempt from taxation; (5) Payments made to reduce or buy down the purchase price of oil to be produced in later periods, by allocating such payments over the production whose price the payment reduces and including the allocated amounts as proceeds for the production as it occurs; and (6) Monies and all other consideration to which a seller is contractually or 	<p>The MMS's definition of gross proceeds is totally open-ended. It states that gross proceeds "include, but are not limited to" and then lists examples. Further, the list of examples included in the proposal is expanded from lists included in previous regulations and regulatory preambles. MMS continues to bring more services and more varied forms of alleged "consideration," under the umbrella of gross proceeds to increase its royalty basis, whether or not such alleged "consideration" was in payment for production. The definition is intentionally broad to allow the MMS to expand that definition on a case-by-case basis and does not elucidate for the lessee the limits to what is considered gross proceeds in order to calculate royalties appropriately and timely.</p> <p>More significantly, through the definition of "gross proceeds," the MMS proposal subjects, not only the lessee, but now any affiliate or other third party under section 206.102(a)(3), to the duty to market at no costs to the government lessor. Current regulations include consideration accruing "to an oil and gas</p>

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	legally entitled, but does not seek to collect through reasonable efforts.	"lessee." This qualifier has now been deleted. Further, the proposed rule includes "gross proceeds," payments for services such as . . . marketing." Although it appears to limit cost responsibility only to those marketing costs that the lessor must perform at no cost to the Federal Government, "the MMS has continued, in the application of current regulations in individual cases, to move the market point at which it would determine royalties further and further downstream of the lease, and to call the enhanced value at downstream markets "marketing costs" which are included in "gross proceeds" subject to royalties. This definition does not give any indication to lessees where MMS will stop. In fact, subsection (5) references "a[] other consideration to which a <u>seller</u> [not just the <u>lessee</u>] is contractually or legally entitled." Not only is the MMS moving the market value basis for royalties further downstream of the lease, it is moving the marketing responsibility further down the marketing chain of vendors.
8.	Marketable condition means oil sufficiently free from immunities and otherwise in a condition purchaser will accept under a sales contract typical for the field or area	The current regulation's definition of "marketable condition" references "lease products," a term that has developed through legal precedent and case law in definition "value of production" under federal leasing statutes. MMS proposes to substitute "oil" for this term. This substitution evidences MMS intent to move its royalty valuation off the lease to downstream markers to capture value beyond the lease product. Just where off the lease would be determined on an individual case basis within the MMS discretion, and, of course, that determination would most likely be after the fact, and revealed only through an audit.
9.	Sale means a contract between two persons where:	<p>(1) The seller unconditionally transfers title to the oil to the buyer. The seller may not retain any related rights such as the right to buy back similar quantities of oil from the buyer elsewhere;</p> <p>(2) The buyer pays money or other consideration for the oil; an</p> <p>(3) The parties intent is for a sale of the oil to occur.</p> <p>The definition of sale is not reflective of any commercial understanding of sale or of its definition under Article 2, Sale of Goods of the Uniform Commercial Code, which case law holds applicable to sales of oil and gas. The definition is further confusing as it defines sale by the parties' intent that a sale of oil occurs; it defines the term by use of the term itself. Further, the exclusion from the definition of sale where the seller retains "any related rights such as the right to buy back similar quantities of oil from the buyer elsewhere," has the potential to be applied arbitrarily and capriciously, even where the parties did not intend the contract to be either an exchange or a jury/sale arrangement. Complex transactions will be subject to second-guessing in audits years after production and payment of royalties.</p>

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10.	206.101	<p><i>Transportation allowance</i> means a deduction in determining royalty value of the reasonable, actual costs of moving oil to a point of sale or delivery off the lease, unit area, or communityized area. The transportation allowance does not include gathering costs.</p> <p>MMS has failed to provide for some field or area transmission costs in its definition of "transportation allowance." Gathering may have terminated and the production delivered into facilities for transportation to a point of sales that is still located in the field or area. This is particularly true where the MMS has retained discretion to determine on an individual case basis the parameters of a field or area under those terms' definitions.</p>
11.	206.102a (1) - (3)	<p>(a) The value of oil under paragraphs (a) (1) through (4) of this section is the gross proceeds accruing to the lessee seller under the arm's length contract, less applicable allowances determined under this subpart. See paragraph (c) of this section for exceptions. Use this paragraph to value oil that:</p> <ul style="list-style-type: none"> (1) You sell under an arm's length sales contract; (2) You sell or transfer to your affiliate and that affiliate, or another affiliate, then sells the oil under an arm's length contract; (3) You sell or transfer to another person under a non arm's-length contract and that person, or an affiliate of that person sells the oil under an arm's-length contract; or (4) You sell in the exercise of a competitive crude oil call. <p>Where production is sold under multiple contracts, then the "weighted average of the values established under this section for each contract" is used. Although this requirement has not changed from the current regulations, the expansion of those affiliates subject to gross proceeds from "marketing affiliates selling only the lessee's production" to affiliates, their affiliates, third parties and third-parties' affiliates, who are aggregating supplies from multiple leases and multiple sellers, and who may be producers or may be other marketers, makes the use of "weighted average" unworkable. The molecules of federal production will not be so traceable in these parties' resale market. The concept of lease or field value will effectively be abandoned under such requirement in the expanding complexities of the current market. This is particularly so where federal production is commingled and aggregated with other third-party production at aggregation points that may or may not be on or near the lease and/or that aggregated volumes bundled with other services, which may be services performed on the lease, or may be services off the lease, are resold to multiple third parties at sales points</p>
12.	206.102b (b)	<p>If oil valued under paragraphs (a) (2) or (a) (3) of this section is sold under multiple arm's-length contracts, the value of this oil is the volume-weighted average of the values established under this section for each contract.</p>

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13.	(c) This paragraph contains exceptions to the valuation rule in paragraph (a) of this section. Apply these exceptions on an individual contract basis. (1) If MMS determines that any arm's-length sales contract does not reflect the total consideration actually transferred either directly or indirectly from the buyer to the seller, MMS may require that you value the oil sold under that contract either under Sec. 206.103 or at the total consideration received.	The proposal leaves to the MMS' sole discretion the right to determine whether a contract does or does not reflect total consideration actually transferred to a lessee. The proposed rule does not define the basis for making such a determination. In fact, the link between the "total consideration" and the sales contract is so vague as to include "indirect" transfers. Again, MMS could second guess some interrelationship between a contract and such alleged consideration during audits performed years after production and lessee's payment of royalties. This expansion of MMS valuation base under its proposal is further frightening where the consideration is no longer limited to that "accruing to the lessee," or to the marketing affiliate which marketed only the lessee's production, but also consideration "indirectly transferred" from "buyer to seller," which seller might be an affiliate, its affiliate, a third-party, and that third-party's affiliate, for supplies aggregated from multiple sources, in addition from federal leases. The proposal does not address when indirect is too indirect, especially within the evolving complexities of today's market.
14.	(2) You must value the oil under § 206.103 if MMS determines that the value under paragraph (a) of this section does not reflect the reasonable value of the production due to either: (i) Misconduct by or between the parties to the arm's-length contract; or	The exception to gross proceeds valuation because of "misconduct" by the contracting parties arbitrarily penalizes the lessee for conduct over which it could exercise no control where it is not the contracting party, and particularly, where the contracting party is a third-party or the third-party's affiliate. Further, it is unlikely that the lessee would have access to any information that would make him even aware of any such alleged misconduct.
15.	(ii) Breach of your duty to market the oil for the mutual benefit of yourself and the lessor. MMS will not use this provision to dispute lessees' marketing decisions made reasonably and in good faith. It will apply only when a lessee or its affiliate inappropriately sells its oil at a price substantially below market value.	The proposed rule provides that the lessee may not use gross proceeds for a valuation basis where the lessee has breached its duty to market the oil for the mutual benefit of the lessee and the lessor. MMS recent decisions evidence MMS trend to expand the duty of the lessee to market from a duty to market at the lease, the historical royalty settlement point, to far downstream of the lease. This expansion has occurred as a result of orders issued in response to lessee's appeal of audit decisions often issued years after the accounting period at issue. The proposed rules do not define any point along the market stream beyond

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		<p>which MMS will not reach for enhanced value. In the July 16, 1998 revisions of the proposed rules, MMS states that it will not dispute "lessee's marketing decisions made reasonably and in good faith." What constitutes reasonable and good faith marketing decisions is not provided in the proposal. These are purely subjective standards. It will only be after years after the fact of production and payment of royalties that MMS will, within its discretion, apply these standards to marketing decisions during audit.</p> <p>What is even more disturbing, under these revisions to its initial proposal, is MMS' stated intention that it will apply this provision when the oil is sold "substantially below market value." First, is the question of what constitutes "substantially below." Second, is the question of what is "market value." This statement creates a Catch-22 for the lessee. It allows the MMS to bootstrap into §201.102(a) whatever benchmark it desires to use as a measure for "market value," and selectively, on a case-by-case basis, to write out the gross proceeds as a value basis even for arm's-length transactions. Consequently, even though the lessee, or the lessee's affiliate, or an affiliate of the third-party or the third-party's affiliate sold the oil under an arm's-length contract, which should be sufficient to allow the arm's-length price to be deemed market value, now the MMS can come after the fact and determine that it would prefer the price at a higher benchmark, merely determine that the lessee has breached its duty to market, and require the lessee to value production under §201.103.</p>
16. 206.102c	(3) You must use § 206.103 to value oil disposed of under an exchange agreement. However, if you enter into a single arm's-length exchange agreement, and following that exchange you dispose of the oil received in the exchange in a transaction to which paragraph (a) of this section applies, then you must value the oil under paragraph (a) of this section. Adjust that value for any location or quality differential or other adjustments you received or paid under the arm's-length exchange agreement(s). But if MMS determines that any arm's-length exchange agreement does not reflect reasonable location or quality differentials, MMS may require you to value oil under § 206.103. If you enter into more than one sequential exchange agreement to dispose of your production, you must use § 206.103 to value that production.	<p>The proposal arbitrarily restricts a lessee's exchanges from qualifying under §206.102(a), even though the exchanges are arm's-length transactions. Multiple exchanges are a customary practice in the industry. For some lessee's, the rule would create an accounting nightmare. First, it requires the lessee to track federal production through the exchange because royalties are based on the disposition of the exchanged volumes. This is an impossibility. The exchanged volumes are commingled and aggregated with supplies from multiple and varied sources. Sales or further exchanges are made from this aggregated pool of supplies. It would be impossible to determine the transactional end of any specific production. Any allocation system for allocating aggregated volumes among subsequent transactions that would include sales and exchanges would be totally unrealistic. The ultimate outcome would be to eviscerate §201.102(a), leaving it totally void of any purpose or meaning.</p>

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17.	206.103 (a) <i>Production from leases in California or Alaska.</i> Value is the average of the daily mean Alaska North Slope (ANS) spot prices published in any MMS approved publication during the calendar month preceding the production month. To calculate the daily mean spot price, average the daily high and low prices for the month in the selected publication. Use only the days and corresponding spot prices for which such prices are published. You must adjust the value for applicable location and quality differentials, and you may adjust it for transportation costs, under §§205.112 and 206.113 of this subpart.	The Western State Petroleum Association's comments on the inappropriateness of ANS prices for the California market are incorporated by reference. Relative to the applicable locations and quality differentials, the Barent's Report on the inaccuracies of location and quality differentials are also incorporated by reference.
18.	206.103 b) <i>Production from leases in the Rocky Mountain Area.</i> Value your oil under the first applicable of the following paragraphs: (1) If you have an MMS approved tendering program, the value of production from leases in the area the tendering program covers is the highest price bid for tendered program covers is the highest price bid for tendered volumes. You must offer and sell at least 33 1/3 percent of your production from both Federal and non-Federal leases in that area under your tendering program. You also must receive at least three bids for the tendered volumes from bidders who do not have their own tendering programs that cover some or all of the same area. MMS will provide additional criteria for approval of a tendering program in its "Oil and Gas Payor Handbook."	The qualifications that a tendering program must meet in order to be used for valuation purposes are so overly restrictive that this benchmark is virtually useless. First, the lessee or the affiliate must offer and sell at least 33 1/3rd percent of your production from both federal and non-federal leases. First, the production to be considered should be the royalty share, and should not include state and fee interests. To also require a third of total production appears to be an arbitrary percentage. Finally, the proposal artificially restricts from participating those bidders who have their own tendering program without any basis for such exclusion. MMS' statement that it would provide <i>additional</i> criteria in its "Oil and Gas Handbook," creates more uncertainty under the proposed rule, reserving maximum flexibility to the MMS to control this criteria outside rulemaking protections. It is unclear why such restrictions are necessary where the major purpose of tendering programs is to obtain arm's-length prices.
19.	206.103 (2) Value is the volume-weighted average gross under you or your affiliates' arm's-length contracts for the purchase or sale of production from the field or area during the production month. The total volume purchased or sold under those contracts must exceed 50 percent of your and your affiliates' production from both Federal and non-Federal leases in the same field or area during that month	This second benchmark allows discretionary interpretation and review of contracts that provides no comfort zone for lessees attempting to determine royalties values under this benchmark. First, MMS has discretion to review and reassess the arm's-length nature of the lessee or its affiliate's sale of their other production and other aggregated supplies in the field or area and of the lessee's or its affiliate's purchases of other parties' production in the field or area. Second, as discussed relative to the definition of area and field in §20.101, the MMS has discretion to determine the outer boundaries of area and field, which it could exercise in order to include whatever sales or purchase prices it desires in

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		is weighted average calculation. Finally the requirement that total volumes purchased or sold under those arm's length contract must exceed 50 percent of, not only the lessee's production, but also that of the affiliates,' and from not only federal leases, but also non-federal leases in the same field or area [which again MMS defines within its discretion] is clearly an arbitrary condition to using this benchmark. Effectively, MMS presumes that the weighted average price of arm's length sales is not a market clearing price.
20	206.103 (3) Value is the average of the daily NYMEX futures settle prices at Cushing, Oklahoma, for the light sweet crude oil contract for the prompt month, that is, in effect on the first day of the month preceding the production month. Use only the days and corresponding NYMEX prices for which such prices are published. You must adjust the value for applicable location and quality differentials, and you may adjust it for transportation costs, under Secs. 206.112 and 206.113 of this subpart.	As demonstrated by the Report, incorporated here by reference, the NYMEX futures settle prices under this proposed provision has little, if any, correlation to the value of Rocky Mountain production for its inclusion in this section of the proposed rules. The Report, as stated earlier, also disputes the appropriateness of the location and quality differentials relied on by the MMS in this provision.
2:	206.103 (4) If you demonstrate to MMS's satisfaction that paragraphs (b)(1) through (b)(3) of this section result in an unreasonable value for your production as a result of circumstances regarding that production, the MMS Director may establish an alternative valuation method.	Should any of the benchmarks for Rocky Mountain production be unreasonable for a lessee's production, the lessee may challenge the valuation under this proposal. However, the burden is on the lessee to demonstrate the unreasonableness. Reasonableness itself is a subjective standard determined by the MMS within its sole discretion. Further, even should the lessee satisfy this high threshold, it is the MMS which establishes an alternative valuation method, again, within its discretion.
22	206.103 (c) Production from leases not located in California, Alaska, or prices: (1) For the market center nearest your lease where spot prices are published in an MMS-approved publication;	Numerous comments have been filed addressing the spot price calculation in accordance with the MMS formula, which are incorporated here by reference. Again the Report addresses the inappropriateness of the location and quality differentials being relied upon by the MMS for adjustment to value based on spot prices under this proposed provision.

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23	(d) If MMS determines that any of the index price referenced in paragraphs (e), (f), and (g) of this section are unavailable or no longer represent reasonable royalty value, in any particular case, MMS may establish reasonable royalty value based on other relevant matters.
24	(e) What if I transport my oil to my refinery and believe that use of a particular index price is unreasonable? (1) If you transport your oil directly to your or your affiliate's refinery, or exchange your oil at arm's length for oil delivered to your or your affiliate's refinery, and if value is established under this section at an index price, and if you believe that use of the index price is unreasonable, you may apply to the MMS Director for approval to use a value representing the market at the refinery. (2) If the MMS Director approves a value representing market value at the refinery, you may not take an allowance against that value under §§206.112(c) and 206.113(b).
25	If you determine the value of your oil under this subpart, you must retain all data relevant to the determination of royalty value. You must be able to show how you calculated the value you reported, including all adjustments for location, quality, and transportation, and how you complied with these rules. Record keeping requirements are found at parts 207 and 217 of this title. MMS may review and audit such data, and MMS will direct you to use a different value if it determines that the reported value is inconsistent with the requirements of this subpart.
26	What are my responsibilities to place production into marketable condition and to market production? You must place oil in marketable condition and market the oil for the mutual benefit of the lessee and the lessor at no cost to the Federal Government unless otherwise provided.

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	<p>In the lease agreement. If you use gross proceeds under an arm's-length contract in determining value, you must increase those gross proceeds to the extent that the purchaser, or any other person, provides certain services that the seller normally would be responsible to perform to place the oil in marketable condition or to market the oil.</p>	<p>defined in terms restrictive to the lessee, but rather the "seller," and services to which the provision applies, are not restricted to those performed by the lessee, but by the "seller," i.e., an affiliate, the affiliate's affiliate, a third party and the third party's affiliate under §201.102(a). Neither the duty to market or marketable conditions references any restriction as to the lease. No specific points of sale or market location is referenced to which the duty to market is limited. The expanding responsibility of the lessee and its affiliate is also described in Point No. 3 above.</p> <p>11. This proposed provision is meaningless as a result of its non-binding effect.</p>
27	206.107	You may ask MMS for guidance in determining value. You may propose a valuation method to MMS. Submit all available data related to your proposal and any additional information MMS deems necessary. MMS will promptly review your proposal and provide you with a non-binding determination of the guidance you request.
28	206.109c	(c) Are there limits on my transportation allowance? (1) Except as provided in paragraph (2)(2) of this section, your transportation allowance may not exceed 50 percent of the value of the oil as determined under this subparagraph. You may not use transportation costs incurred to move a particular volume of production to reduce royalties owed on production for which those costs were not incurred
29.	206.110a	(a) If you or your affiliate incur transportation costs under an arm's-length transportation contract, you may claim a transportation allowance for the reasonable, actual costs incurred for transporting oil under that contract, except as provided in paragraphs (a)(1) and (a)(2) of this section. You must be able to demonstrate that your contract is arm's length. You do not need MMS approval before reporting a transportation allowance for costs incurred under an arm's-length contract. (1) If MMS determines that the contract reflects more than the consideration actually transferred either directly or indirectly from you or your affiliate to the transporter for the transportation, MMS may require that you calculate the transportation

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	MMS 2ND FURTHER SUPPLEMENTARY PROPOSED RULE DATED 7/16/98 allowance under §206.111. (2) If MMS determines that the consideration paid under an arm's-length transportation contract does not reflect the reasonable value of the transportation due to either
	(i) Misconduct by or between the parties to the arm's length contract; or (ii) Breach of your duty to market the oil for the mutual benefit of yourself and the lessor, then you must calculate the transportation allowance under § 206.111.
30.	206.111a (a) If you or your affiliate have a non-arm's-length transportation contract or no contract, including those situations where you or your affiliate perform your own transportation services, calculate your transportation allowance based on the reasonable, actual costs provided in this section.
31.	206.111 When you use index pricing to calculate the value of production under §206.105, you must adjust the index price for the location and quality differentials and you may adjust it for certain transportation costs, as prescribed in this section and §206.113. This section describes the different adjustments and transportation allowances that could apply.